

DIRECT TESTIMONY  
OF  
JAMES ZOLNIEREK  
PUBLIC VERSION

TELECOMMUNICATIONS DIVISION  
ILLINOIS COMMERCE COMMISSION

AMERITECH  
DOCKET NOS. 98-0252/0335 (Consol.)

November 3, 2000

1   **Q.     Please state your name and business address.**

2

3   A.     My name is James Zolnierrek and my business address is 527 East Capitol Avenue,  
4           Springfield, Illinois 62701.

5

6   **Q.     By whom are you employed and in what capacity?**

7

8   A.     I am employed by the Illinois Commerce Commission as a Senior Policy Analyst in  
9           the Telecommunications Division.

10

11   **Q.     Please state your education background and previous job responsibilities.**

12

13   A.     I earned my Bachelors of Science degree in mathematics from Michigan State  
14           University in 1990. I also earned from Michigan State University both a Master of  
15           Arts degree in economics in 1993 and a Doctor of Philosophy degree in economics  
16           in 1996.

17

18           I have been a Visiting Professor of Economics in the Department of Economics at  
19           both the University of Nebraska and Arizona State University. I have taught a variety  
20           of economics courses to both graduate and undergraduate students at both of these  
21           institutions and at Michigan State University while I completed my doctoral studies.

22

Prior to joining the Illinois Commerce Commission I was employed by the Federal Communications Commission (FCC) in the Common Carrier Bureau, Industry Analysis Division. While employed at the FCC my responsibilities included reviewing interstate access rates and policies, and estimating price and revenue impacts of various interstate access price cap modification proposals. I was also responsible for tracking the progress of local telephone competition nationwide. In this capacity I was a co-creator of the FCC Form 477 which surveys the deployment of broadband and local telephone service by both incumbent local exchange carriers and new entrants into local telephone markets. My duties also included general economic consultation on a host of issues examined by the Commission. For example, I provided econometric input estimates for the Universal Service Hybrid Cost Proxy Model and analysis of the progress of long distance competition.

**Q. What is the purpose of your testimony in this proceeding?**

A. The purpose of my testimony is three fold. Ameritech Illinois ("AI," "Ameritech," or the "Company"), and in particular Dr. Harris, have testified that technological change and competitive risks have intensified greatly since alternative regulation was adopted in 1994.<sup>1</sup> As a general matter, I agree that technological change and competitive risks have intensified. I do not, however, agree that Dr. Harris' testimony demonstrates that "...the Commission's expectations regarding competition and technological change have been met," as asserted by Mr.

Gebhardt in this proceeding.<sup>2</sup> My testimony addresses the measurement of competition and in particular the shortcomings of the competition analysis presented by Ameritech and Dr. Harris.<sup>3</sup>

Second, the testimony of Ameritech witnesses Gebhardt and Harris in this proceeding addresses economic considerations applicable to the development of regulated service rates, and offers economic support for Ameritech's new rate design proposal. My testimony addresses the economic analyses of Mr. Gebhardt and Dr. Harris regarding alternative regulation design, and the economic ramifications of Ameritech's rate rebalancing proposal.<sup>4</sup>

The third purpose of my testimony is to address the need for the Commission to collect periodic cost and earnings information from firms subject to an alternative regulation plan. I show that data collection is part of appropriate competition monitoring, and that it provides the commission with information necessary to evaluate the efficacy of its policies.

### **Competition Analysis**

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<sup>1</sup> Alternative regulation was adopted in the Order for Consolidated Docket 92-0448/93-0239.

<sup>2</sup> Ameritech Illinois Ex. 1.1 at p. 82.

<sup>3</sup> Dr. Harris presents his competition analysis in Ameritech Illinois Exhibit 4.0 and its accompanying Schedules.

64 **Q. In Ameritech Exhibit 4.0 and accompanying schedules Dr. Harris has**  
65 **presented an analysis of competition in Ameritech Illinois service territory.**  
66 **What is your assessment of Dr. Harris' analysis?**

67  
68 A. Ameritech Illinois proposes to increase its pricing flexibility, asserting that it must do  
69 so in order to remain competitive in the marketplace. Therefore, the burden of proof  
70 for demonstrating that such additional flexibility is warranted falls squarely on  
71 Ameritech, particularly since Ameritech possesses information that the Commission  
72 does not regarding prices, costs, demand, and earnings. The competition  
73 analysis presented by Dr. Harris does not meet this burden. Dr. Harris has  
74 presented an incomplete picture of competition that in many cases, as indicated  
75 below, implicitly portrays more competition than, in fact, exists.

76  
77 Dr. Harris' testimony contains no analysis of market or pricing power. Absent  
78 market imperfections, firms operating in competitive markets will be forced to  
79 charge the "market price." A firm that attempts to charge a higher price will lose its  
80 customer base to a competitor which charges a lower price. Market power exists  
81 when the market in question lacks effective competition. In the absence of  
82 regulatory intervention firms in imperfectly competitive markets are able to charge

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<sup>4</sup> Dr. Harris and Mr. Gebhardt address rate design in Ameritech Illinois Exhibits 4.1 and 1.2, respectively. Ameritech's rate rebalancing proposal is outlined in the Ameritech Illinois Exhibit 9.0 and its accompanying schedules.

83 prices that exceed costs and retain a significant customer base. Therefore, market  
84 power is indicative of the absence of competition.<sup>5</sup>

85  
86 The competition analysis presented in Dr. Harris' testimony does not contain an  
87 analysis of Ameritech Illinois' market power. Rather, his testimony focuses on  
88 "addressability," which he describes as the "...reach of competitors to where the  
89 customers, lines, and revenues are in the market." Dr. Harris provides anecdotal  
90 and statistical evidence throughout his testimony in Ameritech Exhibit 4.0 that  
91 Ameritech Illinois currently faces more competition than it did in 1994. His analysis,  
92 however, contains no evidence that Ameritech Illinois has experienced a reduction  
93 in market power in any specific market.

94  
95 This omission is particularly troubling given that Ameritech cited pricing concerns in  
96 its arguments before the Commission advocating the movement to alternative  
97 regulation. For example, in that proceeding (Consolidated Dockets 92-0448 and  
98 93-0239), the Commission described the company's position, noting "The  
99 Company contends that, as the telecommunications industry becomes more  
100 competitive, the Commission simply will not be able to meet its commitment to full  
101 capital recovery because prices will be set by the marketplace rather than by the  
102 Commission." In addition the Commission referred to testimony by Dr. Harris

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<sup>5</sup> Economists typically measure competition in terms of pricing power. For example, see Varian, Hal, Microeconomic Analysis, New York, N.Y.: W. W. Norton & Company, Inc., 1992, p. 215<sup>5</sup> which states "A competitive firm is one that takes the market price of output as being given and outside its control." Similar definitions of competition can be found in virtually all economics texts.

103 stating that "...Illinois Bell's market share of intraMSA calling does not demonstrate  
104 market dominance, because its rates are much lower than the other IXC's in the  
105 market." These arguments clearly indicate Ameritech's cognizance of the  
106 relationship between pricing or market power and competition, and call into  
107 question the absence of a market power analysis in Dr Harris' testimony in this  
108 proceeding.

109  
110 **Q. PUA section 13-502, paragraph (b) states "A service shall be classified as**  
111 **competitive only if, and only to the extent that, for some identifiable class or**  
112 **group of customers in an exchange or group of exchanges, or some other**  
113 **clearly defined geographical area, such service, or its functional equivalent,**  
114 **or a substitute service, is reasonably available from more than one provider,**  
115 **whether or not any such provider is a telecommunications carrier subject to**  
116 **regulation under this Act." Does Dr. Harris' notion of "addressability"**  
117 **conform to this competitive classification criteria and, therefore, remove the**  
118 **need to consider market power?**

119  
120 **A.** No. Although I am not an attorney, it does not appear to me that the addressability  
121 analysis performed by Dr. Harris conforms to the standards defined by the Act. In  
122 his testimony in this proceeding, Dr. Harris notes that "the scope of local  
123 competition has increased to where CLECs have investments in place that can

124 readily serve most of Ameritech Illinois' business and residential customers.”<sup>6</sup> This  
125 ubiquitous “addressability” belies the fact that, in many instances, particularly for  
126 residential customers, no CLEC, even if collocated in an exchange provides local  
127 exchange service. An examination of incumbent market power will reveal whether  
128 the lack of competitive provision is indicative of fiercely competitive pricing by the  
129 incumbent provider or whether customers within the exchange simply do not have  
130 access to alternative providers.

131  
132 **Q. In his testimony, Dr. Harris has identified several new technologies that**  
133 **consumers are using in lieu of Ameritech services. Does this suggest that**  
134 **Ameritech's market power has decreased appreciably?**

135  
136 **A.** No. Dr. Harris suggests that ILECs, including Ameritech Illinois, face competition  
137 from providers using new technologies and providing new bundles of services.<sup>7</sup> Dr.  
138 Harris does not, however, address the degree to which such substitutes have  
139 reduced the market power of Ameritech Illinois in the market for local exchange and  
140 exchange access services.

141  
142 For example, Dr. Harris points out that some customers are entirely substituting  
143 mobile wireless telephone service for traditional wireline telephone service, while  
144 other customers place calls on their mobile wireless phones that they would

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<sup>6</sup> Ameritech Illinois Exhibit 4.0 at page 17.

145 otherwise place on their wireline telephone.<sup>8</sup> However, the same arguments could  
146 be made of postal service. Some consumers choose to correspond exclusively  
147 through the mail rather than via telephone, while many consumers substitute some  
148 postal service usage for telephone service usage. Dr. Harris presumably would not  
149 argue that the U.S. Postal Service is a competitive threat to incumbent telephone  
150 providers.

151  
152 When examining the alternative regulation plan it is important to consider how much  
153 such services reduce the market power of the incumbent provider of local exchange  
154 and exchange access services. Dr. Harris has not provided any compelling  
155 evidence that Ameritech Illinois has lost significant market power in the local  
156 exchange and exchange access markets to providers using new technologies or to  
157 providers of new bundles of services.

158  
159 It is again noteworthy that in the proceeding that established the Alternative  
160 Regulation Plan in 1994, Ameritech presented some of the very same  
161 addressability concerns presented in this proceeding. For example, the order cites  
162 Mr. Gebhardt's concerns that the "...the most potent competitive force of all is the  
163 cable television ("CATV") industry. Nationally, CATV companies pass 90% of  
164 residential households and 55% of the households in Illinois are subscribers." This

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<sup>7</sup> Dr. Harris presents a description of new technology and service bundles in Ameritech Illinois Exhibit 4.0 with detail in Ameritech Exhibit 4.0, Schedule 3.

<sup>8</sup> Dr. Harris presents an analysis of the competitive ramifications of wireless provision in Ameritech Illinois Exhibit 4.0 with detail in Ameritech Illinois Exhibit 4.0, Schedule 4.

argument is strikingly similar to concerns expressed in Dr. Harris' testimony in this proceeding.<sup>9</sup> In fact, in 1994 cable companies in the Ameritech service territory offered very few, if any, customers local exchange and exchange access service, and the "potent competitive force" of the CATV industry has not yet resulted in Ameritech Illinois customers having real choice in providers of local exchange and exchange access services. These examples illustrate why the addressability analysis presented in Ameritech's testimony does not adequately portray competitive conditions in the local exchange and exchange access markets.

**Q. Is there any indication that Ameritech Illinois retains significant market power in the market for local exchange and exchange access services?**

A. Yes, particularly for the residential market. The increase in residential rates proposed by Ameritech in this proceeding suggests that Ameritech retains significant market power for residential local exchange and exchange access services in Illinois. Because the proposal to raise residential rates has been suggested by Ameritech, it is safe to assume that Ameritech does not expect to lose a significant portion of its residential customer base from such an increase. In fact, the revenue figures presented by Ameritech's Mr. Van Lieshout assume virtually no decline in Ameritech's residential access line volumes and an increase

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<sup>9</sup> For example, Dr. Harris makes note of the fact in Ameritech Illinois Exhibit 4.0, Schedule 3, at page 12, that "AT&T's cable facilities, excluding Media One, provide the capability to serve approximately one-third of the nation's homes."

185 in residential access line revenue.<sup>10</sup> If residential access line rates in some areas  
186 are below Ameritech's cost of provision, as suggested by Mr. Gebhardt and Dr.  
187 Harris, it is unlikely that Ameritech faces significant competition in those residential  
188 markets.<sup>11</sup> Alternatively, residential rates may be near or above cost. In either  
189 case, the fact that Ameritech believes it can raise rates by \$2.00 without losing a  
190 significant portion of its residential customer base is indicative of significant market  
191 power.

192  
193 **Q. Is there any other indication that Ameritech Illinois retains significant market**  
194 **power in the market for local exchange and exchange access services?**

195  
196 A. Yes. The numbers presented by Mr. Dominak on behalf of Ameritech imply that the  
197 unadjusted return on net original cost has increased from 9.4% in 1995 to 19.2% in  
198 1999.<sup>12</sup> These figures do not imply a significant decline in Ameritech Illinois' market  
199 power in the intrastate local exchange and exchange access markets. While these  
200 numbers could indicate excessive earnings in non-competitive services that mask  
201 reduced earnings in increasingly competitive segments of the market, Ameritech's  
202 own numbers indicate just the opposite.

203  

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<sup>10</sup> Ameritech Illinois Exhibit 9.0, Schedule 3.

<sup>11</sup> In Ameritech Illinois Exhibit 1.1 at page 45, Mr. Gebhardt states "As the company will demonstrate in its rate design filing on July 31, 2000, residence network lines in Access Area C (64% of Ameritech Illinois residence lines) do not even cover their economic (i.e., LRSIC) costs. Similarly, Dr. Harris notes in Ameritech Illinois exhibit 4.1 at page 25 that "...residence network access line rates are no longer compensatory."

Since 1994 a number of services provided by Ameritech under the alternative regulation plan have been reclassified as competitive. Logically, one should find more evidence of diminished market power for such services than for those services still considered non-competitive under the alternative regulation plan. Ameritech's own figures, however, indicated precisely the opposite. Mr. Gebhardt has provided estimates in his testimony (Ameritech Illinois Exhibit 1.1, Schedule 7) of the overall return on non-competitive regulated services excluding regulated competitive services for each period from 1995 through 1999.<sup>13</sup> Mr. Gebhardt reports that the maximum annual rate of return for non-competitive services for this period was 3.88% reached in 1999. The rate of return for competitive services suggested by combining Mr. Gebhardt and Mr. Dominak's figures exceeds █% in every year between 1995 and 1998 and the return on these services exceeds █% in 1999.<sup>14</sup> Therefore, Ameritech's own figures indicate that it retains significant pricing power, particularly for services that it has designated as its most competitive.

**Q. Mr. Gebhardt explains this result by stating that "Competitors are targeting high margin services and customers first, so noncompetitive services**

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<sup>12</sup> Ameritech Illinois Exhibit 7, Schedule 3.

<sup>13</sup> Staff witness Marshall notes in her testimony that there is no reliable method for calculating Ameritech Illinois' returns on non-competitive services, and that Ameritech has declined to do so in the past for this reason.

<sup>14</sup> In Ameritech Illinois Exhibit 1.1, Schedule 7 Mr. Gebhardt presents an overall return on non-competitive services of 1.52%, -0.41%, 2.91%, 1.38%, and 3.88% for 1995, 1996, 1997, 1998, and 1999 respectively. Therefore, the rate of returns on competitive services directly implied by Mr. Gebhardt's numbers are █%, █%, █%, █%, and █%, respectively, for 1995, 1996, 1997, 1998, and 1999.

222 typically have lower than average margins.”<sup>15</sup> What is your assessment of  
223 Mr. Gebhardt’s explanation?  
224

225 A. Mr. Gebhardt’s statement effectively illustrates why market share should be  
226 considered when examining competition. In Ameritech Illinois Exhibit 4.0 Dr. Harris  
227 provides extensive testimony regarding the degree to which the potential for  
228 competition has increased between 1994 and 1999. The high margins for  
229 competitive services implied by the figures presented by Mr. Gebhardt and Dr.  
230 Harris indicates that actual competition is still nascent for many of the services  
231 classified as competitive. Thus, while competitors may very well be targeting high  
232 margin services, the continued high margins presented in Ameritech’s testimony  
233 suggest the company retains significant pricing power for such services. The  
234 competitive analysis presented by Ameritech is insufficient to prove its case.  
235 Specifically, the competitive analysis presented by Ameritech does not provide  
236 enough evidence of competition to contradict its own evidence that is earning  
237 extraordinary returns on services it has classified as competitive.  
238

239 Q. Should the Commission consider the potential for competition from  
240 providers using new technologies and bundling traditional telephone  
241 services with new telecommunications offerings when reviewing the  
242 alternative regulation plan?

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<sup>15</sup> Ameritech Illinois Exhibit 1.1 at page 78.

243

244 A. Yes. I agree with Dr. Harris that when examining the alternative regulation plan the  
245 Commission should consider how such regulation affects Ameritech's ability to  
246 compete in a dynamic and uncertain environment, where new services are being  
247 bundled with old services and technology is changing rapidly. I also agree with Dr.  
248 Harris that the Commission recognized this need when it approved the current  
249 alternative regulation plan in 1994. When considering competitive concerns,  
250 however, I wish to emphasize that the Commission must remain cognizant of  
251 Ameritech's unique position. The Commission must not only consider how  
252 alternative regulation may impede the ILEC's ability to compete, but also how such  
253 regulation may be employed to prevent the ILECs from leveraging their existing  
254 market power in some markets to new and other existing markets.

255

256 **Q. How could Ameritech leverage its market power in some markets to new or**  
257 **other existing markets?**

258

259 A. Regulation currently imposes constraints on Ameritech Illinois that limit the  
260 company's rates for non-competitive services. In order to retain market share and  
261 stave off potential competition, Ameritech Illinois has incentives to subsidize  
262 customers that would potentially have competitive choices with revenue it earns  
263 from its captive customers. Given pricing flexibility Ameritech could price  
264 competitive services below cost, while raising prices for non-competitive services

above cost. Furthermore, as the market for advanced services develops, a long run concern is that if competitive services are an integral part of bundles of advanced services, this pricing flexibility may reduce the ability of new providers to compete with Ameritech in the market for advanced services or other services in the bundles.

**Q. Do you believe that Ameritech currently leverages its market power in some markets to new or other existing markets?**

A. As my testimony indicates, I do not believe that competition for local exchange and exchange access or for advanced services has yet become ubiquitous for Ameritech Illinois customers. Therefore, I do not believe Ameritech Illinois' has yet faced strong incentives to cross-subsidize competitive services with non-competitive services, or to leverage its monopoly power into other markets. However, as competition increases any such incentives built into the alternative regulation plan will increase, making such anti-competitive behavior more likely.

**Q. What steps could the Commission take in order to address such concerns?**

A. The current design of the alternative regulatory plan contains necessary competitive safeguards. The division of services across market baskets limits the flexibility of carriers to cross subsidize non-competitive services with competitive services. The Commission should not weaken those protections by accepting Ameritech's

proposal to combine baskets. I recommend the Commission reject Ameritech's proposal to combine all services into one price cap basket.

The Commission should also be aware that under the current alternative regulation plan Ameritech Illinois has taken certain steps, outlined by Staff witness Koch, to circumvent the competitive safeguards built into the plan. Also, as indicated above, Ameritech Illinois has reclassified non-competitive services to the competitive category, thereby removing these services from the price cap system altogether. While competitive reclassification is not before the Commission in this proceeding, the propriety of such reclassification has an impact upon the effectiveness of the plan.

**Q. Is it your contention that there is no effective competition in the entire local exchange and exchange access market?**

A. No. My contention is that the analysis provided by Dr. Harris has not demonstrated that Ameritech has lost a substantial degree of market power in any market. Dr. Harris asserts that "...virtually all of its [Ameritech Illinois] customers – including residential customers – are easily accessible to competitors that are willing to make the effort to persuade them to switch."<sup>16</sup> However, as I and other Staff witnesses demonstrate, the testimony presented by Ameritech in this proceeding belies the

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<sup>16</sup> Ameritech Illinois Exhibit 4.0 at page 44.

increase in competitive pressure implied by this assertion. I do not contend that Ameritech does not face competitive pressure for some services in some areas. For example, Ameritech Illinois asserts that it has lost 100,000 retail business lines in the past year; if true, such losses are indicative of competitive pressure in the retail business market.<sup>17</sup> Because Dr. Harris does not indicate whether losses are simply transfers from retail to wholesale, however, there is insufficient evidence in his testimony to identify whether such losses have eroded Ameritech's market power in the wholesale market for business local exchange and exchange access lines. Therefore, Dr. Harris has presented an incomplete picture of competition that in many cases, as outlined above, implicitly portrays more competition than, in fact, there is.

#### **Alternative Regulatory Rate Design Analysis**

**Q. Should service rates be cost based?**

A. Yes. I concur with both Dr. Harris and Mr. Gebhardt who argue that non-cost based prices typically result in economic inefficiency. Additionally, I concur that where no market imperfections exist, competition will result in cost based pricing. I caution, however, that when evaluating the alternative regulation plan, efficiency should not be the only evaluation criteria.

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<sup>17</sup> Ameritech Illinois Exhibit 4.0, Schedule 2 at page 2.

329

330 **Q. Are there problems with using efficiency alone as the evaluation criteria?**

331

332 A. Yes. Unquestionably, if a regulatory change can be implemented that improves the  
333 welfare of some without decreasing the welfare of others, then such a change  
334 should be implemented. It is rarely the case, however, that choices are so simple.  
335 Often, as is the case with Ameritech's new rate design proposal, some customers'  
336 welfare improves while other customers' welfare decreases. Efficiency is not a  
337 definitive evaluation criteria in such situations.

338

339 **Q. Assuming Ameritech's rate rebalancing proposal results in rates that are**  
340 **closer to costs than the existing alternative regulation plan, does**  
341 **Ameritech's new plan improve social welfare?**

342

343 A. Only if certain conditions are met. Ameritech's rate rebalancing proposal illustrates  
344 an important difference between the potential for an improvement in social welfare,  
345 based on an efficiency criterion, and an actual improvement. As indicated above,  
346 Ameritech's proposed plan will improve the welfare of some customers, but  
347 decrease the welfare of other customers. Assuming Ameritech's proposed plan  
348 would result in rates that are closer to costs than the existing rates, the value of  
349 gains to those consumers that benefit from the change will exceed the losses to  
350 other consumers. Therefore, those consumers that benefit could compensate those

consumers that do not for their losses, and still retain some benefit from the change. With proper redistribution of funds some consumers' welfare could increase without any decrease in welfare for the remaining consumers.

Such a redistribution of funds to compensate consumers made worse off is not a part of Ameritech's new plan.<sup>18</sup> Without the proper redistribution of funds Ameritech's plan cannot be judged solely on the criterion of efficiency. While efficiency is a necessary criterion that regulatory changes should meet, it is not a sufficient criterion. Equity should also be a consideration.

Moreover, it is not clear that Ameritech's plan would align rates more closely with costs. The costs referenced by Ameritech are costs estimated by Ameritech based upon LRSIC methodology. Dr. Harris and Mr. Gebhardt go to great lengths to point out problems with the LRSIC methodology. These suggested faults, in conjunction with the fact that Ameritech has a decided economic interest in inflating non-competitive LRSIC rates (as outlined above) raise concerns about the accuracy of Ameritech's estimates. This alone suggests that the Commission must proceed with caution when considering Ameritech Illinois' proposed modifications to the alternative regulation plan.

**Q. Are cost based prices efficient?**

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<sup>18</sup> In fact, such a redistribution would need to be carefully designed and could in fact be prohibitively expensive.

372

373 A. Where no market imperfections exist, competition will result in efficient cost based  
374 pricing. That is, once prices are set based upon marginal costs there will be no  
375 way to improve the welfare of some customers without reducing the welfare of  
376 others. The solution that is achieved may not, however, be equitable.

377

378 **Q. Does a plan exist that is both efficient and equitable?**

379

380 A. The efficient solution that occurs as a result of marginal cost pricing is by no means  
381 unique. With proper redistribution one could achieve a different final allocation of  
382 goods and services. This alternate allocation could satisfy the same criteria that no  
383 consumer's welfare could be increased without reducing the welfare of other  
384 consumers. Consequently, both the new and the original solution would be efficient.  
385 This simply illustrates that there can be numerous efficient solutions with very  
386 different equity implications. I concur with Dr. Harris and Mr. Gebhardt that to meet  
387 both efficiency and equity criteria prices should be cost based and subsidies should  
388 be explicit rather than implicit.

389

**Q. Mr. Gebhardt points to Ramsey pricing, and similarly Dr. Harris points to the contribution approach, as consistent with economic pricing principles.<sup>19</sup>**

**Please explain how these approaches address efficiency criteria.**

**A.** Ramsey prices can be employed when marginal cost pricing of all services provided by a firm does not provide enough revenue to recover all of that firm's costs. Ramsey pricing dictates that the firm recover the shortfall resulting from marginal cost pricing by marking prices up above marginal cost in inverse proportion to the elasticity of demand for the services. That is, larger markups are charged for services purchased by the customers that are the least likely to change behavior (those with the least elastic demand).

Subject to the pricing constraints Ramsey pricing can yield an efficient solution. In the absence of redistributive subsidies however, Ramsey pricing may not be equitable. Because residential consumers are likely the least responsive to pricing increases, Ramsey pricing recovers revenue shortfalls created by marginal cost pricing disproportionately from residential customers. In adopting alternative regulation the Commission explicitly expressed its equity concerns surrounding

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<sup>19</sup> For example, in Ameritech Illinois Exhibit 1.2 at page 22 Mr. Gebhardt states "Economic pricing principles, such as "Ramsey" pricing, suggest that inelastic services should make more of a contribution to covering non-LRSIC costs than more elastic services – not less." Similarly, Dr. Harris states in Ameritech Illinois Exhibit 4.1 at page 22, "In principle, by first basing the rates on incremental cost and then using the market-based contribution approach to determine the appropriate markup, a revenue-neutral set of price changes will result in better-informed consumer selections, improved static and dynamic efficiency in the selection and deployment of new technologies, and more efficient competition in all telecommunications sectors, not simply the business sector."

Ramsey pricing noting for example that the "...price cap for the residential basket will ensure that services which are highly price-inelastic will not be subjected to Ramsey pricing and will provide a tangible benefit to residential consumers ..."

**Q. Are there competitive concerns related to Ramsey pricing?**

A. The number of substitutes available to customers will significantly influence their response to price changes. Customers purchasing non-competitive services will have few substitutes available and will be less sensitive to price changes. Customers purchasing competitive services will have more substitutes readily available and therefore, will be more sensitive to price changes. Therefore, if Ameritech Illinois chooses to employ Ramsey pricing based upon the response of its own customers to changes in its own prices, it will maintain lower prices for competitive services such as business services at the expense of higher prices for non-competitive services such as residential services, raising potential concerns about compliance with cross-subsidy prohibitions.

**Q. As part of its rate rebalancing proposal, Ameritech proposes to reduce certain non-recurring charges thereby offsetting increased residential network access line revenues with reduced non-recurring charge**

revenues.<sup>20</sup> Please evaluate this proposed reduction in non-recurring charges based upon economic principles.

A. Both Mr. Gebhardt and Dr. Harris argue at length that, for reasons of economic efficiency, residential network access lines should not be priced below cost. I concur with this assessment. I note, however, that neither provides a convincing argument for why such a price floor should not also apply to non-recurring costs or why the residential network access lines currently priced above LRSIC cost (for example in Access Area A) should be increased even further above LRSIC cost.

The Commission must also consider that Ameritech's proposal to price non-recurring costs below their LRSIC costs may be anti-competitive. Reducing new line "hook up" charges below cost may allow Ameritech to retain or acquire new customers by charging below cost prices for new customer "hook ups" and recovering the revenue reduction through increased rates for other non-competitive services. Mr. Gebhardt argues that Ameritech ultimately bears the risk of departing from a cost based pricing approach. However, if Ameritech's rate rebalancing proposal impedes competition, then consumers may bear the ultimate burden.

**Q. Do you recommend, based upon economic principles, that the Commission adopt Ameritech's rate rebalancing plan?**

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<sup>20</sup> In Ameritech Illinois Exhibit 9, Schedule 1, Mr. Van Lieshout lists non-recurring charges that would

449

450 A. No. Efficiency criteria alone cannot determine the appropriate design for an  
451 alternative regulation plan. Both efficiency and equity must be guiding principles.  
452 Some aspects of the plan, such as the increase in the rate for network access lines,  
453 may better align rates with costs and result in an outcome that is closer to one  
454 efficient solution. Other aspects of the proposal, however, such as the decrease in  
455 non-recurring charges, move rates away from costs and move the outcome further  
456 from that solution. Therefore, it is not clear whether the proposal results in a net  
457 movement towards or away from this one efficient solution. Moreover, neither Dr.  
458 Harris nor Mr. Gebhardt have provided any convincing evidence that the efficient  
459 solution that would be approached is one that meets equity criteria consistent with  
460 the goals of the Commission.

461

462 **Q. Are there adjustments that could improve the alternative regulation plan**  
463 **based upon efficiency criteria?**

464

465 A. Neither Mr. Gebhardt nor Dr. Harris make the argument that the changes proposed  
466 will result in more loop charges being collected through flat monthly charges and  
467 less through (Band A and Band B) usage charges. Assuming Ameritech's LRSIC  
468 cost estimates are accurate Band A and Band B usage charges are currently well in  
469 excess of their LRSIC rates, while some residential access lines may be currently

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be reduced under the Ameritech rate rebalancing proposal.

470 priced below their LRSIC rates. Therefore, a movement toward higher per line  
471 charges in areas where lines are currently below costs and lower usage charges  
472 could more closely align rates with costs. Such a change would therefore result in a  
473 solution that is nearer to an efficient solution. Inequities in the final solution could  
474 then be addressed, where deemed appropriate, through explicit subsidy plans such  
475 as the lifeline and link-up programs.

476  
477 **Q. Are such adjustments equitable?**

478  
479 A. Customers that make very few Band A and Band B calls would be made worse off  
480 by this proposed change. Those customers that make many Band A and Band B  
481 calls will benefit from such a proposal. However, all consumers that make Band A  
482 and Band B calls would receive some benefits to offset an increase in the network  
483 access line charge. This has dramatically different equity implications than  
484 Ameritech's proposal where consumers that do not change or sign up for new  
485 services will receive far fewer offsetting benefits to an increase in the network  
486 access line charge.

487  
488 Such an adjustment, if implemented based on appropriate costs, would also  
489 unambiguously move rates closer to one particular efficient level. Therefore, the  
490 benefit to those who do benefit from the change would exceed the losses to those  
491 that are made worse off. Assuming again that rates are based on the proper costs,

this solution would result in rates that recover revenue more directly from cost causers. Therefore, although the resulting outcome may benefit some at the expense of others, it may be a result that better meets both efficiency and equity criteria consistent with the goals of the Commission.

**Periodic Data Collection**

**Q. Should the Commission look at costs and earnings when reviewing alternative regulation?**

A. Yes. The shortcomings in the competitive analysis presented by Dr. Harris in Ameritech Illinois Exhibit 4.0 highlight one of the reasons such information is valuable to the Commission. That is, earnings and cost information assist the Commission in evaluating competitive conditions.

Earning and cost information also allow the Commission to monitor the effectiveness of its policies and identify implementation problems. As I indicate above, one of the potential problems with rate flexibility in alternative regulation plans is that services priced below cost may be subsidized by services priced above cost. Earnings and cost information can alert the Commission to instances of such rate imbalances and allow the Commission to make appropriate responses. For example, as noted above, both Dr. Harris and Mr. Gebhardt have testified in this

proceeding that rates for residential access lines are below cost in some areas, implying that other services are priced above cost.

Additionally, cost and earnings information allows the Commission to evaluate the effectiveness of its implementation of the alternative regulation plan. The earnings and subsequent returns cited above in the testimony of Mr. Gebhardt and Mr. Dominak imply that non-competitive services are well below cost (when costs of capital are included), while competitive services are well above costs. The earnings figures presented by Ameritech shed light on this reclassification problem.

Periodic review of firm costs and earnings helps to reduce informational asymmetries between carriers and the Commission and to inform the Commission as to the effectiveness of its policy decisions over time. That is, all else equal, the more information about industry conditions the Commission possesses the better will be its ability to design and implement the alternative regulatory plan.

**Q. Does this conclude your testimony?**

**A. Yes.**